

**Introduced by Senator Migden**

February 22, 2005

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An act to amend Section 25110 of the Revenue and Taxation Code, relating to taxation.

**LEGISLATIVE COUNSEL'S DIGEST**

SB 663, as introduced, Migden. Corporation taxes: water's-edge election: foreign affiliated corporations.

Existing law provides that, in the case of a business with income derived from or attributable to sources both within and without this state, the income is apportioned between this state and the other states and foreign countries for tax purposes in accordance with a specified formula based on the property, payroll, and sales within and without this state. Existing law permits a qualified taxpayer, as defined, to elect to determine its income under a water's-edge election. A water's-edge election provides that only the income and apportionment factors of certain described affiliated corporations may be included for purposes of determining the taxpayer's income apportioned to this state.

Existing law requires that income and apportionment factors of a foreign corporation be included in the combined report of a taxpayer making a water's-edge election, but only to the extent of the foreign corporation's United States-source income and apportionment factors. The income and apportionment factors of a controlled foreign corporation, as defined in the Internal Revenue Code, that is an affiliated corporation of a taxpayer are included in the combined report of the taxpayer making a water's-edge election to the extent of the "Subpart F" income ratio, as determined under existing law. Existing law, however, does not specify whether the United States-source income rules or the rules regarding "Subpart F" income,

as defined in the Internal Revenue Code, apply to income of a controlled foreign corporation that has both United States-source income and “Subpart F” income.

This bill would clarify that existing law prohibits a controlled foreign corporation from excluding its “Subpart F” income from a water’s-edge combined report, even if it is a California taxpayer or has income from a United States source. This bill would also clarify that existing law requires inclusion in a water’s-edge combined report of both United States-source income and Subpart F income of a controlled foreign corporation, regardless of whether the corporation is a California taxpayer. This bill would declare that this clarification is operative for taxable years beginning on or after January 1, 2005. This bill would require the Franchise Tax Board to promulgate regulations to prevent the potential double taxation of income when a controlled foreign corporation has both United States-source income and “Subpart F income.”

Vote: majority. Appropriation: no. Fiscal committee: yes.  
State-mandated local program: no.

*The people of the State of California do enact as follows:*

- 1 SECTION 1. Section 25110 of the Revenue and Taxation
- 2 Code, as amended by Section 58 of Chapter 182 of the Statutes
- 3 of 2004, is amended to read:
- 4 25110. (a) Notwithstanding Section 25101, a qualified
- 5 taxpayer, as defined in paragraph (2) of subdivision (b), that is
- 6 subject to the tax imposed under this part, may elect to determine
- 7 its income derived from or attributable to sources within this
- 8 state pursuant to a water’s-edge election in accordance with the
- 9 provisions of this part, as modified by this article. A taxpayer that
- 10 makes a water’s-edge election shall take into account ~~the that~~
- 11 ~~portion of its own income and apportionment factors of the~~
- 12 ~~following and the income and apportionment factors of its~~
- 13 ~~affiliated entities only to the extent provided below:~~
- 14 (1) *The entire income and apportionment factors of any of the*
- 15 *following corporations:*
- 16 (A) Domestic international sales corporations, as described in
- 17 Sections 991 to 994, inclusive, of the Internal Revenue Code and
- 18 foreign sales corporations as described in Sections 921 to 927,
- 19 inclusive, of the Internal Revenue Code.

~~(2)~~

(B) Any corporation (other than a bank), regardless of the place where it is incorporated if the average of its property, payroll, and sales factors within the United States is 20 percent or more.

~~(3)~~

(C) Corporations that are incorporated in the United States, excluding corporations making an election pursuant to Sections 931 to 936, inclusive, of the Internal Revenue Code, ~~of which more than 50 percent of their voting stock is owned or controlled directly or indirectly by the same interests.~~

~~(4) A~~

(D) *Export trade corporations, as described in Sections 970 to 972, inclusive, of the Internal Revenue Code.*

(2) (A) *With respect to a corporation that is not described in paragraphs (1) to (3), inclusive, or subparagraphs (A), (B), (C), (D) of paragraph (5), but only (1), as provided in either one or both of the following clauses:*

(i) *The income and apportionment factors of that corporation to the extent of its income derived from or attributable to sources within the United States and its factors assignable to a location within the United States in accordance with paragraph (3) of subdivision (b). Income of that corporation derived from or attributable to sources within the United States as determined by federal income tax laws shall be limited to and determined from the books of account maintained by the corporation with respect to its activities conducted within the United States.*

~~(5) Export trade corporations, as described in Sections 970 to 972, inclusive, of the Internal Revenue Code.~~

~~(6) Any affiliated~~

(ii) *The income and apportionment factors of that corporation which that is a “controlled foreign corporation,” as defined in Section 957 of the Internal Revenue Code, if all or part of the income of that affiliate is defined in Section 952 of Subpart F of the Internal Revenue Code (“Subpart F income”). The income and apportionment factors of any affiliate to be included under this paragraph shall be to the extent determined by multiplying the income and apportionment factors of that affiliate corporation without application of this paragraph subparagraph by a fraction (not to exceed one), the numerator of which is the*

1 “Subpart F income” of that corporation for that taxable year and  
2 the denominator of which is the “earnings and profits” of that  
3 corporation for that taxable year;

4 (B) For purposes of this paragraph:

5 (i) “Subpart F income” means “Subpart F income” as defined  
6 in Section 952 of the Internal Revenue Code.

7 (ii) “Earnings and profits” means “earnings and profits” as  
8 described in Section 964 of the Internal Revenue Code.

9 ~~(7) (A)~~

10 (3) The income and apportionment factors of the  
11 ~~above-enumerated~~ corporations described in subdivision shall be  
12 taken into account only ~~if to the income and factors extent that~~  
13 ~~they would have been taken into account had no election been~~  
14 ~~made under Section 25101 if this section had not been enacted.~~

15 ~~(B) The income and factors of a corporation that is not~~  
16 ~~described in paragraphs (1) to (3), inclusive, and paragraph (5)~~  
17 ~~and that is an electing taxpayer under this subdivision shall be~~  
18 ~~taken into account in determining its income only to the extent~~  
19 ~~set forth in paragraph (4).~~

20 (4) The Franchise Tax Board shall prescribe regulations to  
21 coordinate implementation of subparagraph (A) of paragraph (2)  
22 to prevent multiple inclusion or exclusion of income and factors  
23 in situations where the same item of income is described in both  
24 clauses.

25 (b) For purposes of this article and Section 24411:

26 (1) An “affiliated corporation” means a corporation that is a  
27 member of a commonly controlled group as defined in Section  
28 25105.

29 (2) A “qualified taxpayer” means a corporation which does  
30 both of the following:

31 (A) Files with the state tax return on which the water’s-edge  
32 election is made a consent to the taking of depositions at the time  
33 and place most reasonably convenient to all parties from key  
34 domestic corporate individuals and to the acceptance of  
35 subpoenas duces tecum requiring reasonable production of  
36 documents to the Franchise Tax Board as provided in Section  
37 19504 or by the State Board of Equalization as provided in Title  
38 18, California Code of Regulations, Section 5005, or by the  
39 courts of this state as provided in Chapter 2 (commencing with  
40 Section 1985) of Title 3 of Part 4 of, and Chapter 9 (commencing

1 with Section 2025.010) of Title 4 of Part 4 of, the Code of Civil  
2 Procedure. The consent relates to issues of jurisdiction and  
3 service and does not waive any defenses a taxpayer may  
4 otherwise have. The consent shall remain in effect so long as the  
5 water's-edge election is in effect and shall be limited to  
6 providing that information necessary to review or to adjust  
7 income or deductions in a manner authorized under Sections 482,  
8 861, Subpart F of Part III of Subchapter N, or similar provisions  
9 of the Internal Revenue Code, together with the regulations  
10 adopted pursuant to those provisions, and for the conduct of an  
11 investigation with respect to any unitary business in which the  
12 taxpayer may be involved.

13 (B) Agrees that for purposes of this article, dividends received  
14 by any corporation whose income and apportionment factors are  
15 taken into account pursuant to subdivision (a) from either of the  
16 following are functionally related dividends and shall be  
17 presumed to be business income:

18 (i) A corporation of which more than 50 percent of the voting  
19 stock is owned, directly or indirectly, by members of the unitary  
20 group and which is engaged in the same general line of business.

21 (ii) Any corporation that is either a significant source of  
22 supply for the unitary business or a significant purchaser of the  
23 output of the unitary business, or that sells a significant part of its  
24 output or obtains a significant part of its raw materials or input  
25 from the unitary business. "Significant," as used in this  
26 subparagraph, means an amount of 15 percent or more of either  
27 input or output.

28 All other dividends shall be classified as business or  
29 nonbusiness income without regard to this subparagraph.

30 (3) The definitions and locations of property, payroll, and  
31 sales shall be determined under the laws and regulations that set  
32 forth the apportionment formulas used by the individual states to  
33 assign net income subject to taxes on or measured by net income  
34 in that state. If a state does not impose a tax on or measured by  
35 net income or does not have laws or regulations with respect to  
36 the assignment of property, payroll, and sales, the laws and  
37 regulations provided in Article 2 (commencing with Section  
38 25120) shall apply.

39 Sales shall be considered to be made to a state only if the  
40 corporation making the sale may otherwise be subject to a tax on

1 or measured by net income under the Constitution or laws of the  
2 United States, and shall not include sales made to a corporation  
3 whose income and apportionment factors are taken into account  
4 pursuant to subdivision (a) in determining the amount of income  
5 of the taxpayer derived from or attributable to sources within this  
6 state.

7 (4) “The United States” means the 50 states of the United  
8 States and the District of Columbia.

9 (c) All references in this part to income determined pursuant to  
10 Section 25101 shall also mean income determined pursuant to  
11 this section.

12 SEC. 2. (a) The amendments made to Section 25110 of the  
13 Revenue and Taxation Code by this act shall be applied to  
14 taxable years beginning on or after January 1, 2005.

15 (b) It is the intent of the Legislature that no inference be drawn  
16 in connection with any matter governed by Section 25110 of the  
17 Revenue and Taxation Code for any taxable year beginning  
18 before January 1, 2005, with respect to the amendments made to  
19 Section 25110 of the Revenue and Taxation Code by this act.